

**More Can Be Done to Help Taxpayers Comply
With Alternative Minimum Tax Provisions**

September 2001

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 25, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – More Can Be Done to Help Taxpayers
Comply With Alternative Minimum Tax Provisions

This report presents the results of our review to evaluate the effectiveness of the Internal Revenue Service's (IRS) efforts to inform and assist taxpayers in complying with the Alternative Minimum Tax (AMT) provisions for individuals before they file their tax returns and during return processing.

In summary, we found the IRS could do more to help taxpayers comply with AMT provisions before they file their tax returns and during return processing. The IRS could improve the letter process used during return processing and could improve tax forms and instructions.

We recommended that the Commissioner, Wage and Investment Division: (1) revise the letter sent to request a missing AMT form during return processing to better explain AMT and to include the return items and amounts the IRS used to determine that AMT was due, (2) revise the return processing procedures to send this letter to taxpayers filing a Schedule E, and (3) insert a page reference to the AMT instructions on the AMT line of the tax return and consider inserting cautionary statements regarding AMT on the return and in the instructions.

Management's response was due on September 20, 2001. As of that date, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or M. Susan Boehmer, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

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More Can Be Done to Help Taxpayers Comply With Alternative Minimum Tax Provisions

Background

The purpose of the Alternative Minimum Tax (AMT) is to help ensure that all taxpayers with significant income pay at least a minimum amount of tax. The Congress first enacted a form of minimum tax over 30 years ago when it was reported that 155 high-income taxpayers had paid no income tax for Tax Year 1966. This tax has been revised over the years, resulting in the current AMT, which affects many middle-income taxpayers.

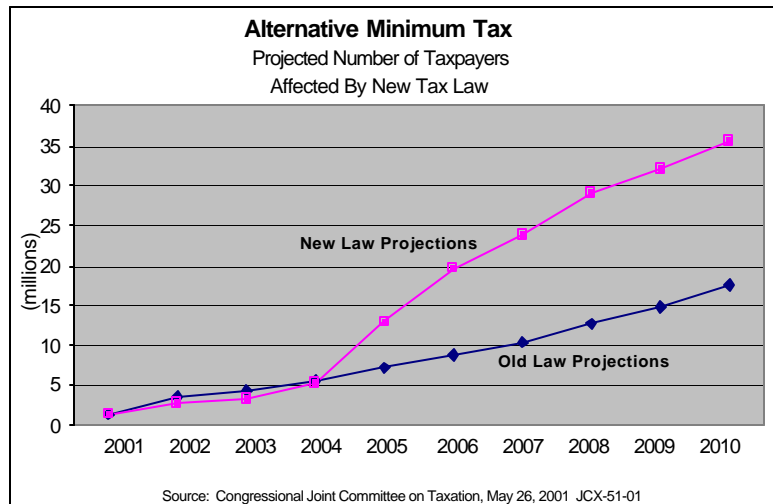
AMT does not affect only taxpayers with complex returns. For example, taxpayers with high real estate taxes, high state income taxes, or a large number of dependent exemptions may owe AMT. In addition, taxpayers that refinance their homes and use the excess funds for such things as paying off credit cards, buying a car, paying school expenses, or taking a vacation must complete the AMT form¹ and may owe AMT. Due to the complexity of AMT provisions, many taxpayers may not know that they meet the criteria for owing it; therefore, they may assume it does not apply to them.

The number of taxpayers affected by AMT is increasing, partly because AMT is not indexed to account for inflation. Approximately 1 million taxpayers reported AMT on their Tax Year 1999 returns. A recent study published by the Joint Committee on Taxation² projects that AMT will affect approximately 35.5 million taxpayers by Tax Year 2010.

¹ Alternative Minimum Tax—Individuals, Form 6251.

² Joint Committee on Taxation, JCX 51-01, dated May 26, 2001. This study considered the effect on AMT of H. R. 1836, which was passed as the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

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When the IRS determines during processing that a taxpayer did not file the required AMT form, the IRS should suspend processing of that return and send a letter to the taxpayer. This process includes sending the taxpayer a letter, which includes the AMT form and related instructions and asks the taxpayer to complete and return the form.³ See Appendix V for an example of the letter.

- When a taxpayer responds to the letter, the IRS processes the return using the AMT amount the taxpayer provides.⁴
- When a taxpayer does not respond, the IRS processes the return with no AMT amount, issues any applicable refund, and sends the return to the Examination function.

We conducted this review at the IRS National Headquarters and the Fresno Campus from December 2000 to February 2001, in accordance with *Government Auditing Standards*. Details of our audit objective, scope, and methodology are

³ Taxpayers filing a U.S. Individual Income Tax Return, Form 1040A may return either the AMT form or the worksheet from the Form 1040A instructions.

⁴ The taxpayer's calculations will be verified during processing and changed if incorrect.

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The Letter Process for Potential Alternative Minimum Tax Returns Needs Improvement

presented in Appendix I. Major contributors to the report are listed in Appendix II.

An IRS goal is to provide top quality service by helping taxpayers understand and meet their tax responsibilities. The IRS could improve service to taxpayers and reduce the number of AMT returns referred to Examination by improving the letter sent during processing and ensuring letters are sent to all taxpayers that potentially owe AMT.

The letter sent requesting the missing AMT form could be improved

The number of taxpayers who do not respond to letters requesting a missing AMT form is growing. During Calendar Year (CY) 1999 processing, approximately 21,700 taxpayers did not respond to the letters. During CY 2000 processing, approximately 23,500 taxpayers (25 percent) did not respond to a maximum of 92,000⁵ letters that the IRS sent.

The letter that the IRS sent to request a missing AMT form did not explain what AMT is and did not provide taxpayers with available information as a starting point for computing their AMT. The letter states: "Information on your return shows you should file Form 6251, Alternative Minimum Tax—Individuals. Please complete the enclosed Form 6251 and return it to us." The IRS did not provide to taxpayers the return items and amounts used to determine that AMT was due. A more informative letter could improve compliance by increasing the number of taxpayers who respond with a completed AMT form and decreasing the number of returns referred to Examination.

The IRS did not send the letter to all taxpayers who potentially owed AMT

When processing returns, the IRS referred potential AMT returns with a Supplemental Income and Loss (Schedule E) to the Examination function without corresponding for the missing AMT form. During CY 2000 processing, the IRS referred over 17,000 returns with a Schedule E to Examination. The IRS did not inform these taxpayers

⁵ See Appendix IV for computation.

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during return processing about their potential AMT liabilities and did not give these taxpayers the opportunity to correct their tax returns before referring the returns to Examination. Approximately 70 percent of the returns referred would not be audited, so these taxpayers would not be informed of their potential AMT liabilities.

This condition was caused by a prior Examination procedure requiring returns with a Schedule E to be referred without corresponding. When this requirement was eliminated, the IRS did not update the return processing procedures to reflect this change.

Recommendations

1. The Commissioner, Wage and Investment Division, should revise the letter sent to taxpayers during return processing that requests the AMT form. The letter should explain what AMT is and should include the return items and amounts that the IRS used to calculate AMT.
2. The Commissioner, Wage and Investment Division, should revise the return processing procedures to send the letter requesting a missing AMT form to taxpayers filing a Schedule E.

Management's Response: Management's response was due on September 20, 2001. As of that date, management had not responded to the draft report.

Tax Forms and Instructions Could Alert More Taxpayers to Possible Alternative Minimum Tax Liabilities

For CY 2000 processing, the IRS identified a maximum of 109,000 returns⁶ that did not include the required AMT form. We expect this number to increase based on a recent study which showed that the number of taxpayers affected by AMT is expected to increase significantly over the next 10 years,⁷ from approximately 1.4 million to approximately 35.5 million.

The IRS should help taxpayers understand the AMT to assist them in meeting their tax responsibilities. Many

⁶ See Appendix IV for computation.

⁷ Between Tax Years 2001 and 2010.

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taxpayers may assume AMT does not apply to them, and IRS tax forms and instructions⁸ do not clearly lead taxpayers to determine if they owe AMT. Certain lines on the tax form have references to the instruction pages where the particular line entry is explained in detail. The AMT line does not.⁹ Also, there is no cautionary statement on the AMT line, in the instructions, or in the regular tax tables to alert taxpayers to possible AMT liabilities. Alerting more taxpayers about AMT when they are preparing their tax returns could reduce the number of returns filed without the required AMT form.

When taxpayers did not file the required AMT form, the IRS either sent them letters to request the form (delaying the processing of their returns) or referred their returns to Examination without corresponding. The IRS also referred the returns to Examination when taxpayers did not respond with a completed AMT form. For CY 2000 processing, the IRS sent taxpayers a maximum of 92,000¹⁰ letters requesting a missing AMT form and referred at least 40,500 returns to Examination.¹¹ Approximately 30 percent of the taxpayers referred to Examination would later be audited for AMT.

⁸ AMT could apply to taxpayers who file U. S. Individual Income Tax Returns, Form 1040 or Form 1040A.

⁹ This applies to the Form 1040. Form 1040A does not have a separate line for AMT; any AMT is included with regular tax on the "Tax" line.

¹⁰ See Appendix IV for computation.

¹¹ This includes the 23,500 taxpayers who did not respond to the IRS' request for the AMT form and 17,000 taxpayers who filed a Schedule E.

Recommendation

3. The Commissioner, Wage and Investment Division, should insert a page reference to the AMT instructions on the AMT line of the tax return. The Commissioner, Wage and Investment Division, should consider inserting cautionary statements on the AMT line of the tax return, in the instructions for the tax line, and in the Tax Tables/Tax Rate Schedules to direct taxpayers to the instructions for AMT.

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate the effectiveness of the Internal Revenue Service's (IRS) efforts to inform and assist taxpayers in complying with the Alternative Minimum Tax (AMT) provisions for individuals before they file their tax returns and during return processing. To accomplish this objective, we evaluated IRS efforts to provide AMT information in the tax forms and tax form instructions and evaluated IRS correspondence sent to taxpayers who filed returns without the required AMT form.¹

We obtained a computer extract of taxpayer data to support various audit tests. This extract consisted of specific tax return information from the IRS Return Transaction File (RTF)² for returns processed during 1999 and for returns processed during 2000 through cycle 200049.³ Our extract criteria was applied to all returns on the RTF for the periods indicated above, and the information was then separated by the tax year of the return (prior year returns can be filed in a current year). The numbers given in the report are for the current year returns processed during that calendar year, for example, Tax Year (TY) 1998 returns processed in Calendar Year (CY) 1999 and TY 1999 returns processed in CY 2000.

- I. We analyzed reports and computer data to obtain background information on AMT, including various statistics about taxpayers that owed or may owe AMT.
 - A. We researched and analyzed prior government and private sector reports on AMT.
 - B. We analyzed IRS RTF information for TY 1998 and 1999 returns.
 1. We determined the number of taxpayers filing and/or paying AMT.
 2. We determined the number of tax returns that were referred to the Examination function when the IRS determined during processing that the AMT form was due.
 3. We determined the number of tax returns from B.2 that had a Supplemental Income and Loss (Schedule E) attached.
 - C. We obtained and reviewed IRS reports for AMT statistics for the Examination function.
- II. We determined if the letter used by the IRS Error Resolution System (ERS) function to request the AMT form adequately informed and educated taxpayers to assist them with completing the form.

¹ Alternative Minimum Tax—Individuals, Form 6251.

² An IRS database containing individual tax return information.

³ One cycle represents one week's processing at the processing centers. The cycle is expressed by a six-digit code. The first four digits are the calendar year of processing. The last two digits are the processing week in that year.

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- A. We determined what information the IRS currently provides to taxpayers when they do not file the AMT form as required.
 - 1. We reviewed the ERS Internal Revenue Manual (IRM) and other processing procedures to determine what letter was sent to taxpayers who did not file an AMT form as required. We analyzed this letter to determine if it was clear and informative. We also determined if it explained what the AMT is, why the AMT form is necessary, and if it included the return items and amounts that the IRS used to determine that an AMT form was required.
 - 2. We reviewed the letter package for completeness and determined if the AMT form and related instructions were included with the letter.
 - 3. We determined if the current instructions for sending the letter requesting a missing AMT form from the taxpayer were clear and appropriate. We interviewed National Headquarters analysts to clarify portions of the IRM and to determine why returns with Schedule E were referred to Examination without first sending the letter.
 - B. We evaluated the effectiveness of the letter in promoting a correct taxpayer response.
 - 1. We interviewed National Headquarters Submission Processing analysts to determine if response rates for requests for the AMT form were tracked.
 - 2. We determined the total number of returns sent to ERS for Error Code 270 (information on the return indicates the taxpayer may be liable for the AMT), because responses were not tracked. We used this information to estimate the number of letters sent.
 - 3. We analyzed IRS RTF data to determine the number of returns being referred to Examination, which would include those with no response to the processing letter and those where no letter was sent.
 - C. We determined how the letter could be improved to educate taxpayers and help them respond with a complete, correct AMT form. We discussed with Submission Processing management the feasibility of adding to the ERS letter the return items and amounts used to calculate AMT that are determinable from the return. We also discussed any ongoing efforts to improve or change the letter or the process for corresponding for the AMT form.
- III. We evaluated the tax forms for individuals and the related instructions to determine if improvements could be made to help make taxpayers aware of the need to consider whether they might owe AMT.
- A. We reviewed the Form 1040 series of tax forms and their related instructions for AMT issues.

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- B. We interviewed National Headquarters Tax Forms and Publications managers about the possibility of adding information to the Form 1040 series of tax forms to alert taxpayers to AMT information in the instructions.

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Computations: Letters Sent and Forms Missing

The Internal Revenue Service (IRS) computer-validates tax return information as the returns are processed. During Calendar Year 2000 processing this validation identified approximately 143,000 returns with potential Alternative Minimum Tax (AMT) errors (situations) where the IRS determined that taxpayers should have calculated AMT, but did not. The IRS could have resolved these potential AMT errors in the following ways:

1. The AMT error was caused by an error on another part of the return that affected the AMT computation. Correcting the other error resolved the apparent AMT error without any other action required.
2. The AMT error was caused by an IRS error directly related to AMT. For example, the IRS incorrectly input a figure from the return that was used in the AMT calculation. Correcting this input error resolved the apparent AMT error without any other action required.
3. The potential AMT return was specially coded and processed. The IRS did not send the taxpayer a letter asking for the missing AMT form.¹
4. When the three situations above did not apply, the IRS should have sent the taxpayer a letter asking for the missing AMT form.

IRS reports showed that situations #2 and #3 accounted for 51,000 errors. Therefore, the maximum number of letters sent would be 92,000 (143,000 less the 51,000). This number is a *maximum* because we could not quantify the number of errors resolved under situation #1.

From our computer extracts we identified approximately 17,000 returns with a Schedule E. These returns would have been included with those in situation #3 and would have been referred to the Examination function without sending letters requesting the missing AMT form. To determine that a maximum of 109,000 taxpayers did not file the AMT form as required, we added the 17,000 returns to the 92,000 maximum number of letters sent.

¹ Alternative Minimum Tax—Individuals, Form 6251.

Letter Example



Department of the Treasury
Internal Revenue Service

FRESNO, CA 93888

In reply refer to:
Dec. 13, 2000 LTR 12F
199712 30 000
00023

Social Security Number:
Document Locator:

Dear Taxpayer:

We received your Dec. 31, 1997 federal income tax return, but we need more information to process your return accurately.

Information on your return shows you should file Form 6251, Alternative Minimum Tax---Individuals. Please complete the enclosed Form 6251 and return it to us.

If you filed Form 1040A, please complete the enclosed Form 6251, or complete the alternative minimum tax (AMT) worksheet in your Form 1040A tax package. Please return the completed Form 6251 of the AMT worksheet to us.

Please send us the information within 20 days from the date of this letter so we can finish processing your return or if you prefer you may FAX us the requested information at 1 (559) 456-5647. FAXing your reply will speed up the processing of your return. If you choose to reply by FAX, please be sure to include any pertinent taxpayer information, such as your name and SSN, with the required information.

Please enclose only the information requested. Do not send a copy of your return. It will take 6 to 8 weeks from the time we receive your response to issue any refund due you. Since we can give you credit for items only if you give us the information to support them, we may have to increase the tax you owe or reduce your refund if we do not hear from you.

If you have any questions about this letter, please write us at the address shown on the letter. If you prefer, you may call the IRS Customer Service telephone line at 1 (800) 829-8815. Employees are available to assist you 24 hours a day.

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Department of the Treasury
Internal Revenue Service

Dec. 13, 2000 LTR 12F
199712 30 000
00024

Whenever you write, please include your telephone number, the hours you can be reached, and this letter. You may want to keep a copy of this letter for your records.

Your Telephone Number: () _____ Hours: _____

We apologize for any inconvenience and thank you for your cooperation.

Sincerely yours,

R. W. HARRIS
CHIEF, DOCUMENT PERFECTION BRANCH

Enclosures
Copy of this letter
Envelope
Form: 6251